



The Corporate Reporting Users' Forum

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Dear Sir David and Mr Herz

## **Performance Reporting**

As analysts and investors, we are writing to you both to express our concerns with regard to some of the proposals made by the IASB and FASB in their review of performance reporting. This letter has been coordinated by the Corporate Reporting Users' Forum, but it has also been signed by a number of analysts and investors who do not normally participate in CRUF meetings but regard this matter as unusually important and so wish to join us in commenting.

### **About the Corporate Reporting Users' Forum (CRUF)**

The CRUF came together in 2005 as a discussion forum with the aim of helping its participants in their approach to the debate on current and future corporate reporting requirements. In particular, participants are keen to have a fuller input into the deliberations of the International Accounting Standards Board.

The CRUF is a discussion forum. Its participants take part in CRUF discussions and joint representations as individuals, not as representatives of their employer organisations. It does not seek to achieve consensus views, though at times its participants will agree to make joint representations to standard setters or to the media. The chairmanship of the CRUF rotates at each meeting and different individuals take leadership in discussions on different topics and in the initial drafting of representations.

CRUF participants include individuals from both buy and sell-side institutions, from both equity and fixed income markets. The forum includes individuals with global or regional responsibilities and from around the world. The CRUF meets on a regular basis in both London and Frankfurt with facilities for remote participation.



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## **General Comments and Observations**

We have been monitoring your progress with the performance reporting project and have recently discussed with our participants a number of the proposals that your Boards have reviewed. We support strongly some of the proposals that have been discussed, but we believe that some of the proposals are flawed. The purpose of this letter is to draw our concerns to your attention at an early stage. We believe that these particular proposals would have a negative impact on the efficiency of the capital markets if carried through to a Standard without being altered, and would be a retrograde step in terms of providing the financial information required by analysts and investors.

We would be delighted to work with you and your Board on these key issues and would welcome an opportunity to meet with you in person to discuss the matters we have raised.

## **Categories and Coherence**

We support the proposal that the financial performance of an entity should be reported in three areas, comprising operating, financing and investing activities. We also support the idea that there should be coherent classifications of these areas in the income statement, balance sheet and cash flow statement. This will address a difficulty that we have with reports prepared in accordance with current standards where it is time consuming or impossible to compare operating performance to the related operating assets and capital employed.

The categorisation between operating, investing and financing will need to be based on high level principles. We do not believe that the Board should seek to specify a single format for the income statement beyond these principles, but we would expect the principles, supported by the accompanying standards, to be such as to deliver a high level of consistency of classification.

## **A Single Performance Statement**

We are indifferent whether there is a single performance statement or whether performance elements are divided between two statements - an income statement and a statement of comprehensive income. We are able to work successfully with either approach. However, whichever approach is adopted, we do need the data to be consistently presented and easily identified from year to year and across companies, so that it does not necessitate a time consuming exercise to pull pieces together. Further, we do need performance elements with different characteristics to be easily identified and separated from each other. For example, re-measurements need to be separated from operating earnings.

## **Earnings or “Net Income”**

A key step in our evaluation of companies is to forecast the future cash flows of the business. To achieve this we require clear and easily accessible data on the historical underlying operating income and costs of the business. In particular, we need to be able to identify quickly the elements that represent operating performance.



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We disagree with the proposal that there should not be an earnings sub-total within a performance statement. We find an earnings sub-total particularly useful in enabling management to communicate with us at a highly aggregated level. Whilst it might surprise some, in our experience professional investors use this critical earnings data to develop their forecasts, rather than using the cash flow statement, because cash flows are highly dependent upon timing differences around period ends.

We recognise that there is no perfect definition of "earnings" and that there are significant risks if there is over dependence on a single number, such as the possibility that it might encourage short-termism. We therefore recognise that there will be a level of diversity in reported earnings. However, the benefits of an earnings sub-total to us as professional investors, and we suspect to retail investors, are high and far outweigh the risks. Further, we suspect that the potential for a short term approach is more a function of management compensation schemes than the reporting of earnings per se.

Because a measure of earnings forms the basis for valuing many companies, managements will inevitably continue to report earnings, even if they are not required by GAAP, but the consequent increase in diversity of how those amounts are calculated will have an adverse impact on the efficiency of the market. The benefit of greater consistency in reported earnings will be to reduce the time and effort we will need to spend to arrive at a suitable measure of operating performance insulated from the distortions that arise from re-measurements and one-off gains and losses.

### **An Objective of an Income/ Performance Statement**

An objective of an income statement should be to make visible both:

- the underlying operating performance of the business, because that is the foundation for our cash flow forecasts; and
- other recognised gains and losses, as these give information about management's effectiveness in delivering on its strategy and often influence our decisions on appropriate risk adjusted discount rates.

### **Principles Underpinning an Income/ Performance Statement**

Consistency in determining and reporting earnings can only be achieved if management has a sound bedrock of principles to guide them, including:

- *earnings reported in the performance statement should exclude the re-measurement of operating and non-operating assets and liabilities, except those arising from short-term trading*

We disagree with the proposal not to require re-measurements of operating assets and liabilities to be separately identified, except when they relate to short-term trading activities.

We need to be able to distinguish re-measurement gains and losses from other income and costs in order to focus on the underlying performance of companies. Re-measurement gains and losses are of themselves generally not useful for forecasting future cash flows from those assets or liabilities, and if they are not identified they impair our ability to determine the underlying operating performance of the business.



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We accept that it will be impractical to arrive at a precise definition of short-term trading, but we can cope with the limited level of diversity that we would expect to arise from this approach.

- ***earnings reported in the performance statement should clearly identify and isolate one-off gains and losses***

A further reason why we disagree with the proposal not to include an amount for earnings in the performance statement is the need to identify and isolate one-off events. There has been a significant increase in one off gains and losses reported under IFRS when compared to previous national GAAPs. We also believe that there will be an increase in these one-off items as a result of a number of the IASB's current projects and the same trend is apparent in US GAAP. With reference to the objectives stated above, being able to exclude such one-off events is critical if we are to forecast the underlying earnings of the current business. However, we also need to be able to assess the returns that management achieved on the entire asset base within its control in any period and separately identifying one-off gains and losses facilitates this too.

- ***the major elements of reported performance should be reported together with their tax effects***

We disagree with the proposal to report just one total for taxation. Tax should be attributed to operations and separately to the major categories of other gains and losses. It is important for us to be able to forecast the tax likely to be suffered on future operating profits and to forecast the cash flow effects of on-off gains and losses in future periods. Presently, such information is obtained directly from companies. This clearly puts some investors at a disadvantage when compared to those with more extensive resources. For example, gains on disposals of subsidiaries should be accompanied by the specific tax effects of that transaction.

- ***the performance statement should include the detail of all of the activities carried out***

We disagree with the current requirements of IAS 1/IFRS 5 and with the Board's proposal that discontinued activities should be presented as a single line item towards the foot of the income statement. As we have already mentioned, there should be enough data on discontinued activities to enable investors to assess management's performance in managing the business until the date of disposal, as well as the key components of gain or loss arising on the disposal itself, including attributable taxation. For example, discontinued activities should be included in full in the aggregate performance statement, but be separately presented within the segment reporting disclosures. The granularity of segment reporting data for discontinued activities should be increased so as to enable key items and totals to be visible.

- ***segment reporting should be a primary statement and contain at least the same level of detail on performance as reported for all businesses in aggregate***

We have yet to see any significant volume of financial statements prepared in accordance with IFRS 8. Whilst we welcome the convergence achieved by IFRS 8, some of our participants have experience in analysing US businesses that produce financial statements using US GAAP and we anticipate that there will continue to be an inadequate level of detail in financial reports to enable us to undertake efficiently a sum-of-the-parts valuation of many companies.



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We would like to see greater detail included in segment reporting and the disclosures elevated to a primary statement to emphasise its importance to us. Our suggested principle is that the data on the performance of individual segments should be no less detailed than the amounts reported in aggregate for the entity as a whole. We are disappointed that the IASB has not taken the opportunity afforded by the introduction of IFRS 8 to improve further on the previous standards (both IFRS and US GAAP) but we hope that this principle could be adopted by both boards as a priority for the future.

We hope that you will find these comments helpful, and we look forwards to an opportunity to discuss our views with you and your Boards in the near future.

Yours sincerely

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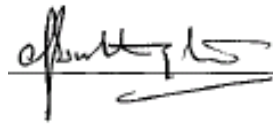
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The following individuals do not currently participate in CRUF meetings but do agree with the observations made in this letter. They sign as individuals and not as representatives of their employer organisations.

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